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SENSITIVE

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TAGS: ECON EINV EFIN KMCA CE
SUBJECT: SRI LANKA: GDP GROWS BY 6% in 2008, BUT PROSPECTS ARE WEAKENING

REF: (a) COLOMBO 215
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¶1. (U) Summary: The Sri Lankan economy grew by a healthy 6% in 2008, despite the fourth quarter global economic slowdown, the escalated conflict in the north, and terrorist attacks elsewhere. Total GDP was $40.1 billion. This translates into a per capita income of $2,014. Inflation surged to 28% in June, but ended the year at 14.4%. Prospects for 2009 are weakening. Initial Central Bank (CB) forecast 2009 growth to be around 5-6%; that will be unattainable. Fitch and EIU estimate growth will slow to 3%. End summary.

GDP UP 6% IN 2008

¶2. (U) According to the Department of Census and Statistics (DCS), the Sri Lankan economy grew by 6% in 2008. Growth fell short of the 7% growth forecasted at the beginning of the year. Nevertheless, 2008 growth once again demonstrated the economy's continued resilience despite the civil conflict. Total GDP was $40.1 billion. Per capita income (in US dollars) was up 23% to $2,014 in 2008 from $1,634 in 2007. A Central Bank official attributed the rapid rise in per capita income partly to the inflationary impact on growth. The stability of the rupee (it depreciated by only 4% while inflation was high) and the low population growth were other factors. According to these statistics, Sri Lanka's total GDP doubled within 4 years, and per capita income doubled within 5 years.

¶3. (U) Inflation (year on year) which was 18.8% in 2007 peaked at 28.2% in June 2008. Inflation was driven by government expenditures and high global oil and commodity prices. In response to these forces, the Central Bank followed a tight monetary policy. As a result, and due to decline in world prices for oil and commodities, inflation slowed to 14.4% in December 2008. According to the latest statistics, inflation has continued to slow, dropping to 5.3% in March.

¶4. (U) All three major economic sectors contributed to growth in ¶2008. Agriculture, which contributed about 13% of GDP, was the main

driver of growth, with a strong 7.5% increase. Paddy (rice) sector grew by over 22%, reflecting the inclusion of more than 133,000 new hectares of cultivated land in the Eastern Province; total paddy production in the three districts in the Eastern Province increased by 27%. Other agricultural produce and livestock from the Eastern Province also recovered. Tea, rubber and coconut production increased and prices reached record levels during the first three quarters due to increased world commodity prices. However, with the spread of global financial problems these export commodities slumped in the fourth quarter. Services, which account for about 57% of GDP, grew by 5.6%, the slowest growth in 6 years. Telecom sector continued its strong growth, with a 22% increase. Tourist arrivals recorded an 11% decline, a direct result of the escalated conflict. The manufacturing sector (including apparel), which accounts for about 18% of GDP, grew by 4.9%. The construction sector which accounts for about 7.5% of GDP by grew by 7.8%.

¶5. (U) External Sector: Imports increased a staggering 24% to $14 billion, mainly due to higher oil and commodity prices. Exports also increased, albeit more slowly, by 6% to $8.1 billion. As a result, Sri Lanka's trade deficit increased 60% to $5.8 billion in ¶2008. Remittances from Sri Lankans working abroad amounting to $2.9 billion helped to partly offset the trade deficit and remained a source of resilience of the Sri Lankan economy. Tourism continued to suffer due to the security situation. While Sri Lanka's exposure to the global financial crisis was limited due to controls on its capital account, Sri Lanka experienced capital flight in 2008 by foreign investors who had invested in government debt instruments. The Central Bank's intervention to maintain a de facto peg at a cost of USD 2 billion saw Central Bank reserves decline to $1.7 billion, or 1.5 months of imports, by December 2008. The rupee was allowed

to depreciate marginally in late December. Overall in 2008, the rupee depreciated by only about 4% against the dollar and appreciated against most other currencies. The appreciation of the real exchange rate has damaged export competitiveness.

PROSPECTS FOR 2009 WEAKENING

¶6. (U) In January, the Central Bank's initial forecast was 5-5.5% GDP growth in 2008, which, it underscored, would likely rise to 6% in response to various government economic stimulus packages. However, government claims to the contrary aside, signs of an economic slowdown are becoming evident. Growth slowed to 4.3% in the fourth quarter of 2008, from 7.6% in 4Q2007. Exports have slowed. Exports fell sharply by 12% in January on top of a 19% fall in December. It will be difficult to repeat the robust performance of agriculture seen in 2008, as agricultural exports are facing uncertain times. Tea production declined by over 40% in the first two months of 2009 due to drought and lower application of fertilizer. Although tea prices recovered in March from a large dip late last year, no one in the industry expects to match last year's revenue. Rubber is suffering from both low production and low prices. The effects of the global economic and financial crises are being felt in the industrial and services sectors. In January, total industrial exports declined by over 5%. Non-apparel manufactured exports such as ceramics, leather, and rubber products declined by over 12%. The services, export/import trade, ports, construction, banking, real estate and tourism sectors are all vulnerable to global recession and domestic financial sector problems, and growth prospects for the year are weak. Apparel exports, expected to decline, increased by 4.5%, but it will be difficult to sustain or increase this throughout the year. On February 27, Fitch ratings said it "expects GDP growth to slow to only 3% in 2009, consistent with recessionary conditions in advanced economies and other emerging markets." EIU also forecasts GDP growth around 3%. Other analysts privately tell post that growth may ultimately be as low as 2.25%. ADB's forecast for Sri Lanka is more optimistic at 4.5%, as it expects the imminent end to the civil conflict to pave the way for reconstruction if financing is available, giving a stimulus to the economy.

¶7. (U) In a bid to stimulate growth, the Central Bank has lowered interest rates. Statutory reserve ratios of commercial banks have

also been significantly reduced. However, lending rates charged by commercial banks remain high with the prime lending rate running over 18.65%. Investment analysts say that lower rates are essential to boost growth. In addition, although government has provided various stimulus packages (refs a and c) there are complaints that implementation is slow. On March 20, Central Bank in a press release noted that "lending has declined sharply." It urged banks to enhance lending so that "credit flow to the private sector is ensured and economic activities in the country are supported, thereby arresting any adverse consequences on the economy." Financial sector liquidity and lending have been affected by slowing exports, loss of confidence, as well as fraud and mismanagement in a popular local credit card company and numerous financial companies connected to it.

COMMENT

¶8. (SBU) The Central Bank -- and its publicly released numbers -- remains very positive about Sri Lanka's and, more specifically, its own performance throughout 2008. Although its actions to reduce inflation may be considered admirable by some, the fact that the country is in negotiations for an IMF Stand-by facility indicates a lack of appropriate fiscal policies and government expenditure restraint. The CB's 2008 report, already overdue for release, is expected to include a revised forecast of projections for 2009.